

BEFORE THE
Federal Communications Commission

WASHINGTON, D.C.

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Implementation of Sections of
the Cable Television Consumer
Protection and Competition
Act of 1992

Rate Regulation

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MM Docket No. 93-215

COMMENTS OF TELE-COMMUNICATIONS, INC.

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SUMMARY

TCI opposes the adoption of the rules proposed in the Further Notice. It does so, first, on the grounds that the proposed rules are precluded by the Communications Act provisions that prohibit Title II, common carrier regulation of cable television and by the 1992 Cable Act provisions that mandate efficient, expeditious, and non-burdensome, regulatory mechanisms. TCI also submits that the rigid, public utility-style, cost-of-service regulation proposed in the Further Notice is inappropriate as a matter of policy, because it is unsuited to providing a backstop mechanism for transitory price regulation in a dynamic industry. TCI takes particular exception to the stated objective of "regulatory parity" between the cable television and wireline local exchange telephone industries.

Addressing the particulars of the proposed rules, TCI urges that the Commission not adopt cost allocation rules for unregulated activities or for external cost adjustments. TCI also urges the Commission not to adopt: (a) a uniform system of accounts for cable; (b) a prescribed industry-wide rate of return, (c) a limitation on prevailing company pricing for affiliate transactions; or (d) a productivity offset. TCI also points out several detailed aspects of the rules' treatment of taxes that need to be corrected.

TCI advocates that the Commission adopt, in lieu of the proposed rules, a flexible, ad hoc approach to a backstop

mechanism for cable price regulation that is based primarily on the presumptive acceptance of cable operators' audited historical books and records. TCI also encourages the Commission to adopt the proposed abbreviated cost-of-service approach to network upgrades as soon as possible.

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COMMENTS OF TELE-COMMUNICATIONS, INC.

Tele-Communications, Inc. ("TCI"), by its attorneys, files these comments in response to the Further Notice of Proposed Rulemaking in the above-captioned docket.

The Commission proposes in this proceeding to make permanent the common carrier-style cost-of-service rules adopted on an interim basis earlier this year,¹ with certain added burdens for cable operators and their regulators. For the reasons stated below, TCI opposes the adoption of the proposals set forth in the Further Notice and advocates instead that the Commission adopt a simpler, more flexible, and less burdensome approach to cable price regulation.

¹ Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation and Adoption of a Uniform Accounting System for Provision of Regulated Cable Service, MM Docket No. 93-215 and CS Docket No. 94-28, Report and Order and Further Notice of Proposed Rulemaking at para. 305, FCC 94-39 (released March 30, 1994) (Cost-of-Service Order or Further Notice).

INTRODUCTION

The Commission's proposal to apply common carrier cost-of-service regulation to the cable industry is impermissible as a matter of law and unwise as a matter of policy. The Communications Act forbids common carrier regulation of cable television and requires that regulation of cable television prices be non-burdensome and expeditious. The Commission's importation into cable television regulation of the principal components and features -- and the attendant regulatory burdens, inefficiencies, and delays -- of traditional telephone common carrier regulation is therefore contrary to the Act. The omission of a few artifacts of telephone regulation cannot, as the Commission contends, legitimize the wholesale adoption of the bulk of such regulation.

Similarly, the Commission's tentative determination to embrace "regulatory parity" between the cable television industry and the local exchange telephone industry fails to recognize that video services are wholly dissimilar -- in concept, content, and use -- from the common carrier service offerings of telephone companies.

Moreover, the proposed cost-of-service regulatory regime is fundamentally inconsistent with the transitory role for price regulation under the 1992 Cable Act. The goal of that Act was to accelerate the growth of a competitive marketplace, not to impose a burdensome, expensive, and durable public utility model.

TCI believes that a properly configured benchmark scheme should be accompanied by a case-by-case, ad hoc "backstop" to which operators faced with the inability to recover their costs through benchmark rates may turn to obtain relief. The backstop system could be efficiently configured around the operators' existing audited books and records, without presumptive disallowances, complex forms, or costly recapitulations of financial data. The 1992 Cable Act neither permits nor requires any more elaborate mechanism.²

I. THE INCORPORATION OF TITLE II COMMON CARRIER REGULATION INTO CABLE PRICE REGULATION CONTRAVENES THE COMMUNICATIONS ACT.

Congress expressly forbade the application of traditional common carrier regulation to cable systems.³ Yet, the Commission

² In these comments, TCI undertakes to address particular aspects of the "interim" and proposed rules that would require revision even if this sort of common carrier regulation were permissible for cable. Such comments are offered in the spirit of constructive criticism and without prejudice to TCI's position that cable price regulation rules premised on common carrier principles are impermissible in their entirety.

³ Section 621(c) of the Communications Act, 47 U.S.C. § 541(c), flatly prohibits the regulation of a cable system "as a common carrier or utility." The legislative history of the 1992 Cable Act confirms the continuing vitality of this prohibition:

The Committee is concerned that several of the terms used in this section are similar to those used in the regulation of telephone common carriers. It is not the Committee's intention to replicate Title II regulation.

* * *

The Committee does not intend for the Commission, in determining the reasonable profit allowed cable operators, to create a traditional "rate of return" comparable to that permitted telephone common carriers.

(continued...)

proposes to impose on cable operators, as a backstop, a cost-of-service scheme virtually indistinguishable from Title II regulation. The replication of Title II regulation in the interim rules contravenes the Communications Act and, therefore, those rules cannot serve as the foundation for the adoption of permanent rules.

The Commission relies on two basic arguments to justify its common carrier type cost-of-service rules. First, the Commission contends that its scheme is permissible because it left out more than a few relatively trivial artifacts of its traditional approach to telephone regulation. Second, the Commission argues that it is permitted to adopt Title II common carrier regulation for cable so long as it labels such regulation as a secondary or backstop mechanism. As demonstrated below, the first justification is factually incorrect and there is no basis in the Communications Act for the second justification.

A. The Interim and Proposed Rules Impermissibly Impose Title II Common Carrier Regulation on Cable Operators.

The Commission asserts that the interim rules are a more "streamlined" approach to rate regulation than Title II regulation,⁴ apparently on the premise that "streamlined" Title II, common carrier regulation is not prohibited. The argument is that the proposed cost-of-service regulatory burdens are

³(...continued)

H.Rep. No. 102-628, 102d Cong., 2d Sess. at 83 (1992).

⁴ Cost-of-Service Order at para. 25.

materially distinguishable from those imposed on telephone companies. That is, of course, inconsistent with the stated goal of regulatory parity. It is also incorrect. In fact, the Commission has imposed on cable operators -- and proposes to maintain -- all of the significant burdens associated with traditional rate of return regulation of telephone companies. Moreover, in the interim cost-of-service rules, the Commission is explicit in its admission that telephone common carrier regulation under Title II has provided the model and most of the details.⁵ Against this background, words like "streamlined" do not conceal the Commission's departure from the Communications Act.

B. The Statutory Prohibition on Common Carrier Regulation Applies Across the Board, Not Just to the "Primary" Approach to Regulation.

The Commission also attempts to justify its imposition of traditional rate of return, cost-of-service, common carrier regulation by noting that its "primary benchmark/price cap approach does not impose the tariff filing, accounting, and cost support obligations" associated with Title II.⁶ Thus, the Commission contends that the imposition of Title II, common carrier regulation on cable is permitted so long as it is imposed

⁵ See id. at para. 24 ("the cost-of-service requirements we are adopting are designed to be consistent with the ratebase/rate-of-return formula that has traditionally been used in public utility regulation").

⁶ Id. at para. 9.

only through a "backstop" mechanism. There is no basis for the Commission's position.

The notion of "primary" and "backstop" methods of regulation is a product of the Commission's rulemaking efforts. It has no basis in -- and no significance to the interpretation of -- the Communications Act. The Communications Act prohibitions on common carrier regulation of cable and the admonitions in the legislative history of the 1992 Cable Act against replication of Title II regulation, draw no distinction between "primary" and "backstop" methods.⁷ Rather, the prohibitions are absolute. The Commission's proposal to disregard the statutory limitations on its price regulation authority should not be adopted.

C. The Proposed Rules Contravene the Statutory Directives to Reduce Burdens and Promote Expedition.

The 1992 Cable Act specifically directs the Commission to adopt price regulation rules -- not just at a "primary" level but across the board -- that are not burdensome to subscribers, cable operators, franchising authorities, and the Commission,⁸ and that admit of expeditious application.⁹ Decades of experience with cost-of-service regulation of public utilities has taught that

⁷ In essence, the Commission's theory is based on the premise that two wrongs make a right: The potentially unconstitutional flaws in the benchmark scheme are rationalized by the existence of a common carrier-style, cost-of-service backstop that the Communication Act forbids, and the adoption of a forbidden common carrier regulatory structure is rationalized by the existence of the constitutionally flawed benchmark scheme.

⁸ See 47 U.S.C. § 543(b)(2)(A).

⁹ See id. §§ 543(b)(5)(B).

such regulation is literally incapable of being applied in a non-burdensome and expeditious manner.

TCI's own experience with cost-of-service showings under the interim rules reveals the magnitude of the burdens: Hundreds of person-hours and hundreds of thousands of dollars have been and will be spent to prepare and prosecute cost-of-service showings before the Commission and local franchising authorities in just two major metropolitan areas. The local franchising authorities invariably invoke their entitlement to extend the time for review of the showings, and face the virtually unavoidable prospect of having to retain expensive legal and accounting consultants to assist in reviewing the showings. All of the expense and time devoted to these efforts reflects lost opportunities for consumers and taxpayers.

II. THE INTERIM AND PROPOSED RULES ARE INCONSISTENT WITH THE BACKSTOP OBJECTIVE.

The rigid and uniform interim and proposed cost-of-service rules are at odds with the "safety net" purpose of backstop regulation. To function as a "safety net" rather than a full-blown regulatory alternative, the backstop regulatory mechanism must be implemented on a case-by-case basis in order to allow cable operators an opportunity to recover their legitimate costs of providing service. The very purpose of backstop regulation is defeated by general rules and rigid forms.

The decision not to recognize the limited and necessarily ad hoc role of backstop regulation has led to several fundamental

errors. First, the Commission's interim and proposed rules establish an extremely elaborate and far-reaching scheme of common carrier-style regulation that not only unduly burdens cable operators electing backstop regulation but also imposes onerous requirements on cable systems regulated under the primary (benchmark) approach.

For example, under the interim rules, cable operators electing benchmark/price cap regulation are required to develop a Uniform System of Accounts ("USOA") and cost allocation procedures for use in external cost calculations,¹⁰ and to comply with affiliate transaction rules for programming costs.¹¹ While TCI believes that no USOA should be adopted for either benchmark or backstop regulated firms, at the very least, these requirements and their associated burdens should not be imposed on cable operators operating under benchmark regulation.

Cost-of-service regulation has already proved to be a far more expensive and time-consuming undertaking than conforming to the benchmarks. TCI's experience discloses that reorganizing accounting data into the Commission's prescribed categories is a particularly costly component of the Commission's cost-of-service process. The Commission asserts that its USOA for telephone companies is similar to GAAP accounting. While it might be true that the recently revised USOA for telephone companies is closer

¹⁰ Cost-of-Service Order at para. 244.

¹¹ Id. at para. 262.

than ever before to GAAP accounting,¹² the attached statement by Mr. M. LaVoy Robison of the accounting firm of KPMG Peat Marwick confirms that there is a very substantial difference between GAAP-based accounting records of an unregulated firm (such as those of the cable television industry) and the FCC's USOA for telephone companies.

Cable operators relying on a backstop regulatory mechanism may well have to devote substantial resources to this endeavor. But cable operators regulated under the benchmark scheme make a different choice, i.e., to rely on averaged industry prices, and avoid the significant expense of a cost-of-service showing. This choice will be unrealistic, however, if benchmark-regulated cable systems are subject to the most expensive and resource-intensive aspects of cost-of-service regulation.

The proposal to have all or a substantial portion of the cable industry alter its accounting practices from those of normal competitive businesses to those of common carriers regulated under Title II is also totally at odds with Congress's intention that cable rate regulation be implemented on a relatively short-term, transitional basis. Moreover, if the costs of complying with these requirements are significant, the Commission may actually be encouraging cable operators to file cost-of-service showings. To avoid this unintended consequence,

¹² Revision of the Uniform System of Accounts for Telephone Companies to Accommodate Generally Accepted Accounting Principles, CC Docket No. 84-469, Report and Order, 50 Fed. Reg. 48408 (November 25, 1985).

absent their election to choose rate of return regulation, cable systems regulated by benchmarks should not be required to comply with cost-of-service requirements.¹³

The Commission's second fundamental error in failing to isolate the burdens associated with backstop regulation is the adoption of industry-wide requirements and broad averaging presumptions. Such sweeping requirements and presumptions are, by definition, inconsistent with the individualized, "safety net" function that motivated the Commission to adopt cost-of-service regulation in the first place. To be effective, such regulation must proceed in a flexible, ad hoc manner through individualized showings that are tailored to the particular circumstances of the cable system.

To a limited degree, the Commission acknowledges this point. In three specific instances, the Commission abandons the application of industry-wide rules in favor of a more flexible approach. For example, the interim rules permit abbreviated cost showings for rate increases needed to support capital improvements and to resolve certain cost allocation issues on a case-by-case basis. The Commission's determination to proceed cautiously¹⁴ in these particular instances should be applied throughout the Cost-of-Service Order and counsels against the

¹³ By the same token, cable operators under cost-of-service regulation should not be burdened with the requirements imposed on benchmark regulated firms, such as requiring the preparation and filing of FCC Forms 393 and 1200.

¹⁴ See Cost-of-Service Order at para. 240.

adoption of permanent rules which are based on the generalized approach reflected in the interim rules.

III. THE COMMISSION SHOULD NOT IMPOSE THE INHERENT INEFFICIENCIES OF TRADITIONAL PUBLIC UTILITY REGULATION ON THE CABLE INDUSTRY.

The Commission has experience with traditional, common-carrier, cost-of-service regulation and undoubtedly is aware of the problems with such regulation. It not only creates disincentives for firms to act efficiently, but cost-of-service regulation is inherently complex, costly, and time-consuming to implement. Applying such an inherently inefficient and complicated regulatory regime to cable, even if it is to serve as a secondary method of regulation, is inappropriate as a policy matter and inconsistent with the stated purpose of the Cable Act.

Congress enacted the 1992 Cable Act and the Commission adopted its implementing rate regulations based on the perceived need to stimulate marketplace forces. Over the course of the past few decades, there has been considerable study and debate on whether traditional cost-of-service principles effectively replicate marketplace incentives. The overwhelming conclusion reached by noted economists and scholars is that it does not.¹⁵ Indeed, cost-of-service regulation produces the very opposite result: It discourages firms from acting in economically

¹⁵ See, e.g., Stephen G. Breyer, Regulation and Its Reform (1982) James C. Bonbright, Albert L. Danielson, & David R. Kamerschen, Principles of Public Utility Rates (1988); Averch & Johnson, "Behavior of the Firm Under Regulatory Constraints," 52 Amer. Econ. Rev. 1052 (1962).

efficient ways. Entities operating a cost-plus business have little or no incentive to take actions that will minimize their costs. Substantial resources have been spent over the years trying to overcome these inefficiencies as regulators have become more aware of the problems associated with traditional, rate of return regulation.¹⁶

Starting from a clean slate, the Commission should adopt a regulatory regime that promotes and encourages efficient, not inefficient, behavior; stimulates, not impedes, marketplace forces; and produces, not thwarts, technological advances. In light of the known inefficiencies of rate of return regulation, it simply cannot be in the best interest of consumers, regulators, cable operators, or programmers to impose this flawed regime on an industry currently free of regulatory distortions.¹⁷

Moreover, the Commission has declared unsuitable the type of scheme it now proposes for cable.¹⁸ Indeed, over the last decade, the trend in governmental price regulation is to move

¹⁶ Of course, the issues are somewhat different in the case of firms, such as the local exchange telephone companies, that have been subject to traditional common carrier, cost-of-service regulation for a long time. In the case of those firms, the disruptions and inefficiencies produced by a change away from the status quo might outweigh the benefits. At a minimum, experience suggests that changes for such firms should be gradual and accompanied by appropriate safeguards.

¹⁷ Application of a productivity offset will not rectify the inherent inefficiencies created by cost-of-service regulation.

¹⁸ See e.g., Policy and Rules Concerning Rates for Dominant Carriers, 4 FCC Rcd 2873 (1989) ("AT&T Price Cap Order"); 5 FCC Rcd 6786 (1990) and Erratum, 5 FCC Rcd 7664 (1990) ("LEC Price Cap Order").

away from rate of return, cost-of-service regulation. This trend away from rate of return regulation extends not only to the Commission and to the state jurisdictions, but also to other regulated public utility industries as well.¹⁹ The rationale for replacing traditional cost-of-service with incentive regulation applies even more so to the cable industry. The inefficiencies and distortions, for example, in the telephone industry, after almost a century of regulation, are nonexistent in the cable business. Application of the traditional rate of return model, however, risks importing many of these same distortions and inefficiencies to the cable industry.

The Commission should heed the experience gained from its price cap proceeding and from other regulated industries which confirms that traditional, cost-of-service regulation, even as a "backstop" mechanism, is not an appropriate model for regulating cable prices.

¹⁹ See H. Rep. No. 103-560, 103d Cong., 2nd Sess 126-127 (1994):

It has become increasingly obvious that regulatory regimes devised decades ago to deal with a vastly different market structure no longer serve industries or consumers Adopting price regulation will continue a trend begun by Federal and State regulators over the last decade. Recognizing the shift from a monopoly to a competitive environment, the FCC and a majority of state commissions have abandoned rate-of-return regulation in favor of incentive regulation.

IV. ESTABLISHING REGULATORY PARITY BETWEEN THE TELEPHONE AND CABLE INDUSTRIES IS NOT AN APPROPRIATE POLICY OBJECTIVE.

The interim cost-of-service rules admittedly impose common carrier-style regulation on cable systems electing backstop regulation with the purpose of establishing regulatory parity between the cable and telephone industries.²⁰ Regulatory parity, however, is an inappropriate policy objective given the differences between the two industries.

The Commission proposes to employ on a permanent basis industry-wide rules and broad averaging presumptions used primarily for mature, static industries. Putting aside the fact that traditional, cost-of-service regulation is inherently inefficient and costly to implement, the use of broad averages and generalized rules may be appropriate for telephony; however, it is not for a dynamic industry such as cable.

The history of the telephone and cable industries is highly disparate. These historical differences justify and require the application of different price regulation schemes. Unlike the cable business, a single integrated firm -- the Bell System -- maintained a dominant position in the telephone industry for over sixty years. The supply of telephony was fully integrated and coordinated in almost every respect. Bell Labs provided the design, Western Electric provided the equipment, the Bell companies built and operated local telephone facilities and services, and AT&T Long Lines constructed and operated the long

²⁰ Cost-of-Service Order at para. 26.

distance network. On an administrative level, all of the management and financial operations of the Bell companies were fully integrated and centralized by AT&T. Even independently owned telephone companies were economically integrated through the separations and settlements process.²¹

Given this high degree of integration and coordination with and among the Bell companies, the use of broad averages and rules of industry-wide application was not only possible but even desirable. To a large extent, cost-of-service regulation mirrored the Bell System's organizational structure and operations. The need to interconnect all segments of the nationwide telephone network, as well as a social policy favoring geographically averaged prices, also made it logical to establish a system of broad cost averaging. Even with the break-up of AT&T, there are still similarities in operations, technologies, and services among the seven regional Bell Companies.

²¹ The integrated nature of the Bell Companies has been acknowledged by the Commission:

The largest exchange carriers which together provide 80% of the nation's access lines, the RBOCs, were purposely set up as seven companies that are quite similar. . . . [T]he RBOCs were divested with similar capital structures, have similar operating assets, and are all about the same size. Their credit ratings are similar. They share the same interstate regulatory environment, and their management shares a common heritage.

Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, CC Docket No. 84-800, 1985 FCC Lexis 2800 (released August 7, 1985).

The commonality of system design, service provisioning, and financial practices has no counterpart in the cable industry. Whereas one Bell System provided service to over eighty percent of the country, there are literally thousands of cable operators that serve the United States. While there has certainly been some consolidation of operations and administrative procedures, most cable systems have widely different engineering, management, and financial practices, and provide various and diverse services to consumers. Moreover, cable systems operate in a variety of ways -- some as subchapter S or C corporations, others as partnerships or sole proprietorships.

Simply put, the homogeneity that exists in the telephone industry has never existed and does not currently exist in the cable industry. The commonality prevailing in the telephone industry permits the use of generalized rules and broad averaging, the lack of it in the cable industry prevents the use of such rules and presumptions.

Along with these structural differences, cable and telephony provide widely different services to consumers. The services to be regulated in this proceeding are not essential services, like telephony. Rather, cable television is an elective service that more than 35 percent of Americans with access to cable do not purchase. This distinction is important. Regulation of pure transmission services, such as telephony, has only marginal First Amendment significance. By contrast, common

carrier regulation of cable may infringe upon fundamental constitutional rights.²²

Further, an unintended consequence of public utility-type regulation may be to change or alter the quality and type of programming provided to consumers. Such effects not only undermine the Commission's goals of encouraging high quality and diverse programming sources, but also may have constitutional implications as well.²³ Because of the significant constitutional issues involved, the Commission must be especially careful -- more so here than with telephony -- to craft a regulatory regime for cable that has minimal impact on speech. Regulatory parity in this context simply cannot and will not work.

V. SEVERAL ASPECTS OF THE COMMISSION'S PROPOSED COST ALLOCATION RULES MUST BE REVISED.

With respect to its interim cost allocation rules, the Commission took a more "cautious" and flexible approach and concluded that it should review the allocators proposed by cable operators on a case-by-case basis.²⁴ TCI believes that this flexible, individualized approach to regulation is far superior to the imposition of "one size fits all" industry-wide rules.

²² See FCC v. Midwest Video Corp., 440 U.S. 689 (1979).

²³ See Turner Broadcasting System v. FCC, 62 U.S.L.W. 4647 (U.S. June 27, 1994) (No. 93-44); Riley v. National Federation of the Blind, 487 U.S. 781, 789 n.5 (1988).

²⁴ Cost-of-Service Order at para. 240.

Nonetheless, there are several areas of concern regarding the interim cost allocation rules which are discussed below.

A. The Commission Has No Reason to Require the Separate Reporting of Unregulated Activities.

In the Cost-of-Service Order, the Commission amended its rules to require cable operators to allocate costs among five service categories: (1) basic service tier activities; (2) cable programming services activities; (3) other cable programming services activities; (4) other cable activities; and (5) noncable activities. Among the activities contained in the last three categories are pay-per-channel and pay-per-program offerings, billing and collection services, studio and unregulated equipment engineering and rental services, and sale and maintenance of unregulated equipment. Because the Cable Act does not regulate the prices of these activities, the Commission has no reason to require the separate reporting of these activities.

Contrary to the Commission's assertion, it is neither necessary, nor lawful, to allocate unregulated costs to various unregulated service categories in order to ensure that the "allocation of costs to regulated services is fair and reasonable in relation to the allocation of costs to unregulated services."²⁵ Once costs are found to be nonjurisdictional, the Commission's legal authority to track these costs is extremely limited. The Commission's interest in ensuring the proper

²⁵ Id. at para. 237.

allocation of costs to regulated and unregulated activities is confined to comparing unregulated costs in toto, not its piece parts.

This view is reflected in the Commission's joint cost rules for telephony, which separate costs between regulated and unregulated activities, but do not further disaggregate purely unregulated costs.²⁶ The telco price cap rules similarly do not contain unregulated service baskets.²⁷ Accordingly, TCI respectfully submits that the Commission should revise its service baskets and establish one unregulated service category.

B. The Cost Accounting and Cost allocation Rules Should Not be Applied to Cable Operators Seeking External Cost Adjustments.

Under the interim rules, cable operators seeking adjustments for changes in their external costs must comply with the cost accounting and allocation rules adopted in this proceeding. Because cost allocation and accounting rules impose substantial burdens on cable operators, the Commission should not require benchmark regulated cable systems to comply with these requirements.

The import of the cost allocation rules in the context of external costs is very unclear. Pass-throughs of external costs are allowed for a very limited group of activities: franchise fees, state and local taxes, costs of franchise requirements,

²⁶ 47 C.F.R. § 64.901.

²⁷ 47 C.F.R. § 61.42.